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Berry, CP, Gamble, Andrew, Hay, Colin, Payne, Anthony and Hunt, Tom (2016) Reorienting the Treasury, Reorienting British Capitalism. In: SPERI British Political Economy Brief. UNSPECIFIED. Sheffield Political Economy Research Institute (SPERI).

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Version: Published Version

Publisher: Sheffield Political Economy Research Institute (SPERI)

Please cite the published version

https://e-space.mmu.ac.uk

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SPERI British Political Economy Brief No. 21

Reforming the Treasury, reorienting British capitalism.

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Introduction

In its dual role as both the 'economics ministry' and the 'finance ministry', HM Treasury sits at the apex of the British state, and indeed the British political economy. This role has received a great deal of critical attention in the wake of the 2008/09 recession and subsequent imposition of 'austerity' by the Conservative-Liberal Democrat coalition government, continued by the Conservative majority government; for example, it is currently being reviewed by former Head of the UK Civil Service, Lord Kerslake, on behalf of the Labour Party. In this Brief, we consider previous attempts to challenge the Treasury's pre-eminence within government over economic policy, and suggest that the Treasury should be accepted as the dominant economics ministry with political capital and effort spent on reforming its role, responsibilities and mandate. Creating an alternative economics department within government – a 'beefed up' business department – will have only a limited impact. The Brief also sets out how and why a 'developmental' approach to the Treasury should be considered and outlines the need for a new growth model and how the Treasury can oversee its development and functioning, before suggesting a new approach for the Treasury to economic stability and regulation.

Part One: Historical context

There have been three previous episodes in the last fifty years where attempts, of varying degrees, have been made to challenge the Treasury's pre-eminence over economic policy and alter the dynamics of economic policymaking within government. Whilst much of this will be familiar, it is instructive to consider these episodes when thinking about the Treasury's role as the economics ministry.

The idea behind Harold Wilson's creation of the Department of Economic Affairs (DEA) in 1964 was to drive the economy towards sustainable growth amid the early signs of industrial decline, and much was made of the benefits of its 'creative tension' with the Treasury. The growth strategy was shattered by the adherence to the parity of sterling by Wilson and Jim Callaghan as Chancellor, and by the resultant Treasury-led cuts which were brought in to defend sterling.

Equally significant when considering the DEA is the extent to which the department was seen to have been created to placate Wilson's main rival, George Brown. After Brown was moved to the Foreign Office in 1966 the DEA languished under the leadership of less senior politicians and the Treasury gradually regained some of the power and influence it lost in 1964. Roy Jenkins, as post-devaluation Chancellor, resisted Wilson's second attempt in 1968 to give the DEA new momentum.

The second episode occurred during the post-1974 government when Tony Benn led an attempt to develop the alternative economic strategy through the Department for Trade and Industry (DTI). This foundered partly due to the Treasury's dominance of the economics agenda (and in particular, its central role in negotiating the IMF bailout and delivering the resultant spending cuts) and additionally because Benn's alternative strategy at the DTI and Healey's Chancellorship were on alternative sides in the growing left/right political divide in the Labour Party and government.

The third, and most collegiate, episode came after the financial crisis of 2008, when Peter Mandelson took charge of the Department for Business, Innovation and Skills between 2008-2010. Operating as a de facto Deputy Prime Minister Mandelson did begin to remake the case for an industrial strategy and to act upon this. However, the primary focus of this period for the beleaguered Brown government was responding to the global financial crisis and again Treasury-led policies were pre-eminent.

The lesson we suggest that should be drawn from these episodes is that creating a new economic department, or viewing a separate institution within government, to be an alternative (a rival?) to the Treasury has not previously worked. This applies both to when politicians of significant stature working closely with the Prime Minister have led an alternative (e.g. Mandelson between 2008-10), and when they have been major political opponents (e.g. Brown between 1964-66). Creative tension between departments when viewed through the prism of domestic politics, and interpreted by the press, quickly looks like internal party splits.

Instead we suggest that political capital and effort would be best placed by reforming the role, responsibilities and mandate of the Treasury and accepting it as the economics ministry. What we now set out should be built into the Treasury, not set up or hung out there as a political alternative.

Part Two: The Treasury's role in a 'developmental state'

As we set out an alternative vision for the Treasury it is worth stating at the outset that the Treasury does not pursue an unchanging orthodoxy. Significant reforms can occur. For a long time the Treasury resisted Keynes and Keynesianism, but eventually it was converted. The Treasury was also initially quite resistant to the adoption of monetarism. What has been constant however is the Treasury's role in controlling public spending and raising taxes, and this gives it its unique influence within government and a particular framework to everything it does. From this role as the controller of state expenditure have emerged some of the Treasury's deepest assumptions – such as the idea that the economy works best with minimal state interference, a small public sector and low public spending. It is these long-held assumptions, along with the Treasury's power to block rather than facilitate, lead and develop, that are in need of reform. Paradoxically, the creation of the Office for Budgetary Responsibility as a separate entity has reinforced the primary role of the Chancellor and the Treasury as being responsible for sound management of the public finances above all else, irrespective of a broader vision of the development of the economy.

We suggest that the review ought to study the 'political economy of development' literature and consider the distinction that is made in this literature between 'growth' and 'development' – the latter is understood as something you build from growth, on the basis of some kind of moral view of the world. Is the Treasury's role, as the title of the review suggests, to simply 'deliver fair and sustained economic growth' or is it to oversee and implement a model of economic development that has sustainable growth at its centre? Considering the developmental state literature and studying examples of where 'developmental state' approaches have been taken around the world (e.g. Japan and South-East Asian states) would help inform this debate.

Models of economic development are often only considered and thought about with regard to 'developing' countries. We would suggest that any review of the Treasury, and of the British state as a whole, should be asking the same analytical questions of Britain that would be asked of countries deemed to be part of the 'developing world. In summary, these questions would include some variants of the following:

- What are the core economic attributes of the country? What can it make and sell best?

- What is the institutional basis of its state? How does it typically act and think?

- What mix of domestic and extra-territorial social forces bear upon the country's governing elite? How do they either sustain or challenge the elite?

- What ideological claims, if any, are being made by the governing elite to promote its strategy and ambitions?

- What are the impacts of any overarching regional arrangements within which the key economic, social and political actors of the country are enmeshed?

- What is the position of the country's political economy in the wider global order and what mechanisms exist to adjust and reshape that position?

Once we have convincing answers to these questions, we can first describe and characterise the overall strategy of development of a country – the model, if you like, that it currently aspires to achieve – and then assess how that model needs to be reformed and remade.

But rather than a developmental state-approach being applied to the existing British state and the Treasury as its economics ministry, a developmental strategy would only work if it is truly embedded within the key institutions of the state.

Following on from this we suggest:

1. The Treasury should be required to publish a clear, explicit and public statement, on an annual or bi-annual basis, of its understanding of the growth model/ model of development of the economy as a whole, against which economic policy choices and economic policy performance might be assessed. We have written elsewhere about the need for growth model transformation and the necessary components that a new growth model could include (Hay and Payne, 2015; Berry, 2016).

2. The current preoccupation with growth alone must be widened and in time the convention of growth should be replaced with a range of more complex and sophisticated indices of economic performance.

3. We suggest this could take the form of a new sustainable economic development index (SED) (Hay and Payne, 2015). In summary, this new compound index might include measures such as changes in the Gini coefficient (in the direction of greater societal equality), changes in per capita energy use (rewarding increased energy efficiency and sustainability), changes in per capita carbon emissions and other planetary boundary statistics (rewarding the greening of residual growth) and perhaps a range of more basic development indices (changes in literacy rates and so forth). This sustainable economic development index would be recorded and published alongside GDP and would thus allow the production of a new hybrid GDP-SED index. Over a timescale, which would need to be agreed at the global scale, the proportion of SED relative to GDP in the hybrid index would rise – from zero (now) to close to 100 per cent (at an agreed point in the future). This would enable us to gauge whether our national economy, and those of other countries, is 'growing', 'flat-lining' or 'in recession' according to the new hybrid index as, in effect, we moved from measuring economic performance in terms of GDP to measuring it in terms of SED.

Part Three: Overseeing the new growth model

As we discussed in Part One, we accept the primacy of the Treasury as the economics ministry but argue that its remit should be broadened. Therefore, all of the key economic functions and responsibilities should be located with the Treasury, in one place. This would enable a Chancellor, with the confidence of the Prime Minister, to have full control over macroeconomic management and spending, and a complete focus on planning growth.

As such, the abolition of the Department of Business, Innovation and Skills as a separate ministry is worth considering. This would entail re-locating control over some aspects of universities policy to the Department of Education, but the major advantage would be to bring into the Treasury all industrial policy functions, including research and innovation, that are at present scattered over a range of departments.

The Chancellor would then have full control over the government's economic agenda and would be tasked with driving this and embedding it within all departments. Organisationally, instead of having a single powerful second-in-command in the Treasury (the Chief Secretary) the Chancellor would have two major deputies (the Chief Secretary and a Secretary for Economic Development), both of whom would attend Cabinet.

To ensure that the growth model was implemented, tested and reviewed we suggest that the following organisational and strategic changes are also worthy of consideration:

1. The Treasury should be charged with responsibility for gathering data on the imbalances in the British economy and monitoring progress towards their rectification. Broadly the indicators that can be used to assess this include the imbalances between the financial and manufacturing sectors, Northern and Southern regions, imports and exports, investment and consumption, and debt

and saving (for a more comprehensive list of indicators of imbalances see Berry and Hay, 2014).

2. The rebalancing of the economy would be driven through a new office for public infrastructure investment and industrial production to be established within the Treasury.

3. Further, a new office for heterodox economics should be established within the Treasury. The office would be charged with stress-testing the Treasury's economic model to identify its blind-spots, engage critically with its assumptions and biases, and to encourage and embed disequilibrium thinking, as well as equilibrium thinking, within Treasury orthodoxies.

4. The Treasury should move away from the biannual cycle of reporting on the public finances. Instead, it should move to biennial reports on (a) the public finances and (b) economic development. These biennial reports would be led and reported by the lead minister, not the Chancellor.

Part Four: Economic stability and regulation

The Treasury also needs to take on a bigger role in ensuring the stability of the overall economy and overseeing the necessary regulation needed to achieve this.

To this end we make the following suggestions:

1. The Office for Budget Responsibility could be brought back into the Treasury (and re-titled the Office for Economic Stability and Sustainability), albeit with some degree of operational independence and a significantly larger workforce. It would be charged with projecting economic performance, and not just or principally in terms of growth (as outlined above), over a five year period of time. Its remit would also be broadened to include a key role in seeking to identify threats to economic sustainability and stability over the same period of time – a form of prospective risk assessment. This would entail close partnership working between the Office for Economic Stability and Sustainability and the new office for heterodox economics.

2. The Treasury could take on principal responsibility for overseeing the Bank of England's financial regulation. This responsibility would be formally underneath its new economic development function. In taking on this new responsibility for regulation the Treasury should apply a precautionary disposition to such regulation and be guided by the following principles:

    a. First, and perhaps above all else, regulation should not just be understood as being about tempering market excess; it needs to serve, and be seen to serve, a wider societal purpose – to help markets contribute to the growth/development model of the economy as a whole.

b. Second, as Paul Krugman has repeatedly outlined since the financial crisis, regulation should be in proportion to the potential risk posed by the object of regulation. Banks, in particular, should be regulated not against universal and rigid rules, but in proportion to their systemic significance to the financial sector as a whole. Thus, we do not so much need a rule that precludes banks from becoming 'too big to fail' (or too big to be allowed to fail), so much as a regulatory regime which ensures both that banks too big to fail do not fail and that the burden of regulation they would endure is a strong disincentive to them ever attaining such a systemic significance in the first place.

c. Following from this, a principle of discretionary precaution in financial regulation and more generally should be adopted. Effective regulation, whether of the energy market or the market for financial innovation, is most effective, not when it is rules-bound but when it is flexible, adaptive, intelligent and transparent. Regulators, as the crisis shows so effectively, need to be risk-averse – even if at times that has the effect of closing off potentially lucrative investment or growth opportunities. They need, in other words, to adopt a strong and consistent precautionary principle. But they also need the authority to demand full and complete information disclosure from the institutions they regulate and a flexible capacity to respond dynamically to the risk assessments they generate on the basis of that information.

d. A further principle follows, with particular significance for complex and dynamic markets such as those for instruments of financial innovation. It is that, in the name of precautionary discretion, we should adopt a presupposition against financial innovation in the absence of a strong counter-vailing case.

e. Finally, regulation (whether domestic, international or global) is best seen as a collective public good. As such, it needs to be delivered through a system that is both public and publicly accountable and therefore based within the Treasury under ministerial control.

Part Five: Operational changes

There is a strong sense that the Treasury has always been suspicious of long-term public investment, which may be why the UK has comparatively little relative to many other countries. The cost of financing long term public borrowing is significantly lower than for commercial lenders. Moreover, public infrastructure projects are likely to be critical to any reconfiguration of the economy towards a new growth strategy. Public investment – especially in infrastructural renewal – is therefore a highly cost-effective way of providing public goods on which the transition to a new model of growth will rely.

The Treasury has also always resisted hypothecated spending, preferring all revenue to be consolidated in a single fund. At a time when it is very hard to raise general taxation this is unhelpful. Hypothecated taxes in certain areas, such as health, might be the way to raise significant extra revenues for public programmes.

In particular, we suggest that the use of public investment or growth bonds – a form of hypothecated debt, and in effect, an ethical form of investment available to financial institutions and private citizens. Funds secured in this way could be earmarked for public infrastructural projects and new sustainable technologies, and might be distributed through a range of national or regional investment banks.

Conclusion

We conclude with a statement made earlier that is worth repeating: the Treasury does not pursue an unchanging orthodoxy. It has shown in the past that it can embrace new ideas, and must do again. If a coming economic crisis may feel like (an all too recent) history repeating itself then it is incumbent on those of us who want a more sustainable form of political economy in the UK to ensure that our response does not repeat the events since 2008. An alternative UK growth model is urgently needed and the Treasury will play a central role in implementing a new model, but it is not enough to reform one institution alone. To bring about that transformation an entire world view is needed which combines political mobilisation, a reform agenda for the state and a policy programme.

This Brief is based on SPERI's submission to the Kerslake Review of the Treasury (see http://www.kerslakereview.co.uk/ for more information).

Further reading

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March 2016

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